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Roots of financial crises in Ukraine and possible methods of its overcoming

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1. Fundamental causes of financial Crises in Russia and Ukraine

Fundamental causes of the recent month and a half collapsing devaluation of Russian ruble and Ukrainian Hrivnya are identical. They are long brewing budgetary crisis and slowdown of the process of structural and systematic reforms in both countries. In the political realm it means the absence of sufficient political will of both executive and legislative branches to pass the decisions which would contribute to reduction of the State's financial liabilities, taxation base's consolidation as well as lifting up of various bureaucratic limitations for entrepreneurial activity which actually prevented the actual economic sphere from coming back to the process of economic growth. Economic growth's absence constitutes an extra factor contributing to fiscal crisis exacerbation.

Under the circumstances of absence of budgetary balancing strict monetary policy could only improve the situation for rather shirt time period. As of beginning of 1995 in Russia and the end of 1995 in Ukraine the countries witnessed the process of switching of financing of budget deficits from the Central Bank's emission to attraction of private loans into the domestic market, issuance of the State treasury bills (GKO) and federal loans bonds in Russia, and the domestic treasury T-bills in Ukraine. Such a policy made it possible to slow down the monery base expansion rate, stabilize the national currencies rate, to lower the inflation (in Ukraine more effectively as compared to Russia) as well as to hold off the DGP's fall. It should be underscored though that such a policy was characterized by one serious drawback that is it did not deal away with the fundamental causes responsible for macroeconomic disbalance since it only provided a certain kind of "breathing space" for both countries' parliaments and governments for the conditions of relative micro economic stability gave them a chance to implement the required fiscal and structural reform as well as to proceed with intensive privatization program. Unfortunately the "breathing space" break proved to be rather short and was not used to implement the reforms required.

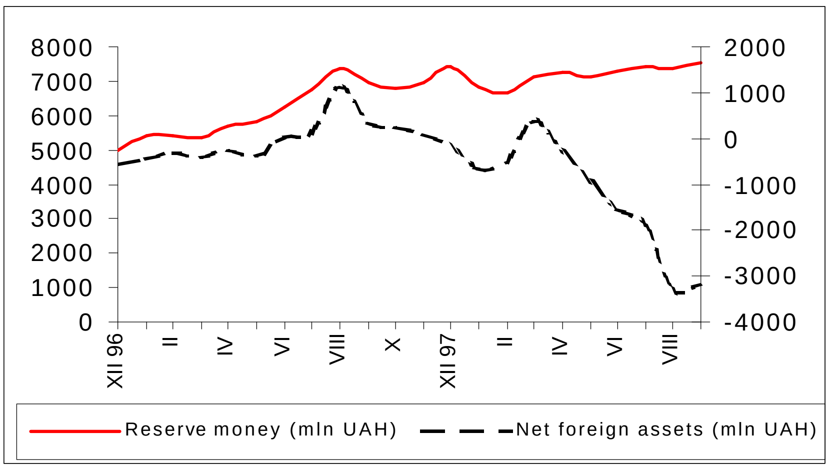
Under low monetization level of both countries the potentials of internal debts increasing were fleetly exhausted. Starting with the second half of 1996 this financing source has actually lost it significance for both Russia and Ukraine. The future presented another opportunity such as the non-residents interest in purchasing of treasury liabilities. Under the circumstances of "emerging markets euphoria" both Russia and Ukraine could have attracted the financial capital by relatively favorable conditions. Although the euphoria proved to be rather short term phenomenon, since the investors have quickly realized the fragility of macroeconomic foundations of both countries. The series of crises in Asian countries have proven to be an extra factor to lower the general confidence into the "emerging markets." As of November 1997 both countries have began to witness mass scale drain of capitals abroad which actually was initiated by non-residents and then joined by the residents and consequently caused rather unpleasant consequences such as difficulties with the budget deficit financing and restructuring (rolling) of the old debt, as well as currency reserves' fast contraction. Amounting doubts of the financial market participants regarding the country's potential's to pay for its own debts have entailed an abrupt surge of treasury bills yield rates along with percentage rates growth on the financial market which actually complicated the budget situation.

Abrupt lowering of the amounts of currency reserves has actually damaged the confidence into the National Currency stability which served as an extra impetus for the residents to switch from ruble/ hrivnya into dollars. It should be underscored that money policy of both countries (Russia and Ukraine) did not prove to be sufficiently severe to prevent the collapsing devaluation. Both the Central Bank in Russia and the National Bank of Ukraine did not undertake the money base sterilization in the process of capital's inflow and currency reserves growth through reduction of the net internal assets.

The correlation of currency reserves and money base remained low which did not make it possible to secure sufficient support of national currency for the event of speculative attack.

Under the conditions of currency reserves drain the Central Banks started to fill in the money base with the additional domestic credit. The National Bank of Ukraine has practically resumed wide scale of budgetary deficit's financing through purchasing of the bonds of state domestic loans (domestic T-Bills) on the primary market (Look at chart 1). It should be underscored though that this was the only choice the government was left with, since the refusal to roll T-bills could have led to the government's default. Actually it is impossible to accuse the government of excessively strict monetary policy in view of the fact that the governmental policy was not sufficiently strict. As of the end of 1997 the monetary policy has actually remained the hostage of fiscal disbalance.

Chart 1. Correlation of the net external assets (net currency reserves) of the National Bank of Ukraine and money base



2. Differences of situations in Russia and Ukraine

In spite of similarity of fundamental causes of devaluation crises the situation in Ukraine did not prove to be as dramatic as the Russian one. What is the difference? The difference characterized both the crises preceding situation and the process of crisis's management.

The first stage of crises showed that compared to Ukraine Russia proved to be more vulnerable due to the following:

1. The level of accumulated state debt of Russia was higher compared to Ukraine. Such a situation is the result of Russia's former Soviet Union debts inheritance as well as its much earlier launch of the treasury liabilities which under the conditions of high budgetary deficit speeded up Russia's entering into debt's trap.

2. Federal State arrangement of Russia has contributed to complications of the fiscal discipline's problems in both countries.

3. Foreign trade structure of Russia is distinctly different from Ukraine's one. Russia has suffered significant losses due to the lowering of world's prices for oil, natural gas and other primary resources. Whereas Ukraine has actually benefited from such change in prices. Much

stronger reliance of Russia's consumer market on import implies that devaluation in Russia entails much more serious inflation consequences as compared to Ukraine.

4. Ukraine has actually received a "bonus" for procrastination of financial sector's reform. Ukrainian banks unlike Russian ones have not managed to take loans at the international market and consequently have not entered the large scale of derivative operations, which contributed to their more balanced positions and consequently made them less vulnerable in regards to devaluation. Hence, Russian crisis is exacerbated by both the absence of balance in the budget and banks' fragile financial standings.
5. Underdeveloped stock market has actually helped Ukraine to avoid additional capital's drain.
6. Powerful structures of financial oligarchy are absent in Ukraine whereas in Russia the State and economy have actually become such structures' hostages.
7. Irrespective of substantial drawbacks of Ukraine's fiscal policy as of beginning of the current year Ukraine has managed to achieve certain lowering of budget's deficit whereas in Russia it was still very high.

Following August 15, 1998 significance differences were observed in the methods two countries chose to use to manage the crises:

1. Ukraine did not declare the official default of T-bills and the deplorable Russia's experience has actually helped to "convince" investors of the need of voluntarily indebtedness' conversion.
2. NBU and Government of Ukraine have avoided passage of strict resolutions relating to commercial banks; such resolutions in Russia have only contributed to panic. On the other hand the NBU has demonstrated its ability to implement the measures required to reorganize banking sector.
3. Financial crises in Russia has quickly turned into governmental crisis , which actually contributed to the panic's enhancement at the currency and financial market. Ukraine so far has managed to avoid serious political contention.

As a result Ukraine's movement along the same crises spiral is much slower as compared to Russia which means that we still have a chance to slow it down even more by means of reduction of the potential inflation scale and GDP fall. Although it very much depends on the adoption of anti crises package as well as on sequence of the measures included into the package.

3. Possible variants of macroeconomic situation's development

Giving prognoses in regards to the potential macro economic development under the conditions of already set financial crises is not an easy task, particularly in view of the possibility of current situation's rapid change and psychological factors tremendous significance. Based on the various assumptions regarding to the speed of anti-crises measures' adoption we shall try to discuss two possible scenarios (pessimistic and optimistic) of the macro economic situation's development.

The main budgetary and monetary policies premises shall be identical for both scenarios:

Deficit financing

1. Access to the private sources of external financing is not available.
2. Internal financing such as T-bills or other securities is not available.

3. Net financing of international financial organizations' credits (World Bank, European Community) is negative or in the best case equals zero.

4. Therefore non-zero budget deficit means financing on account of NBU crediting.

Money base and reserves

1. Continuance of financing of government through NBU under the conditions of impossibility of currency reserves further reduction will consequently lead to the money base expansion. Under the assumption of such financing absence the money base expansion may only be possible on the account of the reserves' accession, possibly through transfer of a certain portions of industrial enterprises' and population currency assets into hrivnya.

2. Even under the most favorable conditions the NBU currency reserves will not increase on account of external loans. In the best case the acquired credits will only be sufficient for the former loans reconciliation.

The variants differ in the speed of anti crises measures' adoption as well as in the scale of financial adaptation. It should be underscored that the pessimistic variant in its practical implementation may prove to be even more destructive as in the estimates presented. Further slip along the crisis spiral may evoke the factors of political and psychological nature (taking into account the Russian experience) which were not considered in our model. For example the speed of monetary circulation (divergence from hrivnya) may prove to be much higher as compared to the assumptions given; budget revenues may drastically reduce (tax payers may use the depreciation of their liabilities to the State as their justification argument), the additional expenditures may increase (Indexation); the likelihood of banking system crises may not also be violated.

Variant 1 (pessimistic).

Ukraine' gradual slip into crises. According to this scenario a number of anti crises measures required to overcome the crises situation were not implemented. This is first of all deals with the raid financial adaptation which means zero deficit or even achievement of cyficit in the course of the whole period duration.

Variant's main characteristics:

- Budget deficit amount to 2.5 in 1998, 1-2 in 1999. Under the circumstances of external and internal financing absence the budget deficit is covered by the NBU's crediting of the government.

- Deficit's financing on account of NBU will promote an increase of domestic net assets. Impossibility of further sterilization on account of reserves' reduction along with the net domestic assets increase may cause the money base expansion which may through monetary mechanisms cause inflation jump, which will entail a drop of confidence in hrivnya and raise inflation expectations.

- Hrivnya's continued devaluation along with the population's inflation expectation provokes a brisk divergence from national currency, increases the speed of money circulation (monetarisation's fall), and exacerbate inflation (Russia's) variant.

- The further contraction of real sector and GDP's decrease were stipulated by the financial system crisis along with the absence of conditions for normal functioning of enterprises due to the administrative pressure (on exporters and importers) and investment’s unavailability. Decrease of population’s incomes caused the reduction of private consuming.

Potential paths of macro economic indications (Variant 1)

Parameter	*1998*	*1999*
Budget deficit, % GDP	*2,5*	*1-2*
Exchange rate HR/ $, end of the period	*4,5-6,0*	*6,0-9,0*
CPI, December to December	*45%*	*60-100%*
Money base growth	*10%*	*20%*
Monetisation level	*10%*	*8%*
Real GDP change	*-2,5%*	*-3%*

Variant* 2. *(optimistic)

The variant is based on the assumption of rapid implementation of measures of (“anti crises program”) which may produce a real “change” of the situation. Such measures must be aimed at curtailment of the further expansion of money base and inflation rate in the course of returning to the balanced exchange rate (look further down).

Strict budgetary adjustment and structural changes implementation must form the key conditions of both stabilization of rate and medium range measure. Pension reform, reform of social protection system as well as accelerated privatization are called to discharge the budget of extra expenses.

Variant’s main characteristics:

- Fiscal balancing of budget. To avoid financing of the deficit of external and domestic sources through emission financed by NBU’s credit changeover to current zero deficit is required. Whereupon the money base’s expansion will become slower as compared to the preceding scenario. Restraining the money base expansion and strict policy aimed at banking system liquidity support may curb the exchange rate and inflation growth simultaneously which will stimulate the resumption of demand for national currency.
- Achieved stabilization must reinstall confidence into hrivnya, which will in the middle range perspective secure the transfer of currency assets of various economic agent’s into hrivnya, which consequently will stimulate the currency supply growth and will help NBU to refill its currency reserves.
- Therefore anti crises program declaration along with the other restraining factors will contribute to likelihood of hrivnya’s rate stabilization within the limits 3.5-4 per 1 USD by the end of 1998.

Potential paths of macro economic indications (Variant 2)

Parameter	*1998*	*1999*
Budget deficit, % GDP	*2,0*	*0*
Exchange rate HR/ $, end of the period	*3,5-4,0*	*4,0-4,5*
CPI, December to December	*30%*	*10-15%*
Money base growth	*5%*	*10%*
Monetisation level	*13%*	*13%*
Real GDP change	*-1,5%*	*-1,0%*

4. Short term anti crisis measures

Short term measures (several weeks perspective) which may slow down the further financial crisis exacerbation include the actions aimed at currency market normalization, finalizing conversion of T- bill liabilities, swift transfer to non-deficit budget (slowing down the further process of accumulation of budgetary deficit as of fourth quarter of current year), launching of wide scale cash privatization.

The mot urgent measure is to return to the free floating [?] hrivnya's convertibility which would imply annulment of administrative restrictions introduced at the currency market at the beginning of September. To avoid the next "jump" of hrivnya's rate under the conditions of annulled restrictions, the National bank of Ukraine may be recommended to implement short term measures aimed at "contraction" of banking system liquidity which is possible to carry out by means of introduction of more strict reservation's norms, observance over the sequence of their implementation, arrangement of depositary auctions etc.

The above mentioned measures must contribute to lifting up of such currency market administrative restrictions which prevent its normal functioning at the moment. Absence of actual exchange rate deprives the subjects of market of information regarding the existing tendencies, and the state of the market leverages of these tendencies' management. Hence the required measures are: liberalization of current trade operations, abolishment of the actually effective tender committee of NBU, canceling of compulsory currency earning sale, annulment of restrictions on repatriation of non-residents' income. Under the current system of regulation these measures form a must in order to have currency market assuaged and exchange rate back to market balance.

Launching the process of cash privatization would simultaneously contribute to achievement of several goals such as: structural reforms' advancement, replenishment the budget with privatization's proceeds, replenishment of currency reserves of NBU (provided that foreign investor participate in the process) and at least partial resumption of confidence into economic policy of Ukraine.

5. Medium term program.

According to our estimates non-deficit budget in short-and medium term's perspective is a required prerequisite to surmount the crisis. Purely technical measures such as sequestering of budgetary expenditures and mobilization of tax levy may not be considered as adequate to achieve the afore indicated budget, since they only result in increase of budgetary indebtedness and flagging of the level of general financial discipline. The required measures are systematic reduction of State's financial liabilities, including the ones in the social sphere. Such a measure will require the pension reform's implementation which would mean: raising of retirement age, imposing of limitations of the right of pre-term retirement, annulment of the other privileges granted to various industries and professions, reduction of the number of pensions due to disablement, reduction of the pension's amounts of working pensioners, reduction of the amount and number of individually entitled pensions. The targeting principle of the other social benefits must also be enhanced. The so-called social privileges such as free acquisition of certain goods and services must also be annulled. Budgetary sphere reform must include the contraction of the network of health care, educational, cultural, establishments along with partial introduction of paid services and implementation of competitiveness mechanism for the right to deliver such services.

Lifting up of a number of political restrictions on privatization process must promote the acceleration of structural changeover of Ukrainian economy, foreign capital attraction, budget replenishment with additional funds. The afore described measures jointly with wide scale deregulation and tax reform must constitute the impetus for private business development and consequently help Ukraine to return to economic growth.

Detail description of the suggested tax reform and deregulation may be found in the regularly presented memoranda of CASE and HIID.

Unlike of the presented earlier suggestions the reform package must be inclusive of the measures aimed at resumption of confidence into national currency and securing of its stability for long term perspective. The current crisis experience dictates the decisions which would secure complete independence of monetary policy from political pressure. Hence, our suggestion is to introduce the currency board system which implies the regime of 100 National currency reservation under the conditions of fixed currency exchange rate to a chosen foreign currency (in practice it might be either US dollar or EVRO) delineated by the respective law. Under the currency board regime the money base must contain 100% funds covered by Central Bank currency reserves, Central Bank is prohibited to use any form of credit for either the government or commercial banks, and to perform open market operations. The rates shall be calculated at the market exclusively. The currency board regime is called to illuminate the possibility of political pressure on monetary policy which must enhance the population's and entrepreneurs confidence into national currency. Under the currency board regime the national currency is a full equivalent of convertible currency (dollar or EVRO). The experience of Argentine, Estonia, Lithuania and Bulgaria demonstrates that currency board regime promotes fast lowering of inflation rate, enforces fiscal discipline, promotes resumption of confidence into national currency as well as help to create the environment conducive for economic growth.

To implement currency board system successfully would require accumulation of sufficient amount of currency reserves (which are scares at the moment) along with securing of budget deficit absence and adoption of the program of banking sector sanation. This means that the new system may only be implemented no earlier than the middle of the next year.